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Understanding the new auditing standards related to risk assessment; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Understanding the New Auditing Standards Related to Risk Assessment

SAS No. 104, *Amendment to Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*

SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards

SAS No. 106, *Audit Evidence*

SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*

SAS No. 108, *Planning and Supervision*

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling

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Notice to Readers

This Audit Risk Alert is intended to provide auditors with an overview of the new risk assessment standards to be used in the planning and performance of a financial statement audit.

This publication is an *Other Auditing Publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Understanding the New Auditing Standards Related to Risk Assessment

Introduction

This audit Alert provides a summary of eight Statements on Auditing Standards (SASs) that provide extensive guidance on how you should apply the audit risk model in the planning and performance of a financial statement audit. These SASs were issued in March 2006 and become effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted. While the time period between the issuance and effective date of the standards may seem long, you should not underestimate the standards' significance and the far-reaching effect they will have on your audits.

The eight SASs[1] consist of:

- SAS No. 104, *Amendment to Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*
- SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards
- SAS No. 106, *Audit Evidence*
- SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*
- SAS No. 108, *Planning and Supervision*
- SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

1. Statements on Auditing Standards issued by the Auditing Standard Board are applicable to audits of privately held entities and other *nonissuers*. The term *issuer* means entities that are subject to the rules and regulations of the U.S. Securities and Exchange Commission and the Sarbanes-Oxley Act of 2002.

- SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling

The Auditing Standards Board (ASB) believes that the SASs represent a significant strengthening of auditing standards that will improve the quality and effectiveness of audits. The primary objective of the SASs is to enhance your application of the audit risk model in practice by requiring, among other things:

- A more in-depth understanding of your audit client and its environment, including its internal control. This knowledge will be used to identify the risk of material misstatement in the financial statements (whether caused by error or fraud) and what the client is doing to mitigate them.
- A more rigorous assessment of the risk of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The development of these SASs was undertaken in response to recommendations to the ASB made by the former Public Oversight Board's Panel on Audit Effectiveness. In addition, the major corporate failures of the past several years have undermined the public's confidence in the effectiveness of audits and led to an intense scrutiny of the work of auditors, and the development of the SASs also have been influenced by these events.

How the Risk Assessment Standards Affect Current Practice

The SASs incorporate many of the underlying concepts and detailed performance requirements that exist in the current standards. However, the SASs do create significant new requirements for auditors.

In most cases, implementation of the SASs will result in an overall increased work effort by the audit team. It also is anticipated that, to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. To ease the implementation process, it is recommended that firms adopt at least some of the provisions of the standards in advance of the required implementation date.

How This Alert Is Organized

This Alert is organized into three different parts.

- *Part One: Key Provisions of the SASs and How They Differ From Current Standards*. This part provides a summary of some of the key provisions of the SASs and how they differ, if at all, from current audit standards.
- *Part Two: Fundamental Concepts*. This part summarizes the guidance in the SASs relating to fundamental audit concepts such as materiality, financial statement assertions, and audit evidence.
- *Part Three: Applying the Audit Risk Model*. This part of the Alert provides a summary of the application of the audit risk model as described by the SASs.

Part One: Key Provisions of the SASs and How They Differ From Current Standards

This section discusses the key provisions of each of the SASs and provides a summary of how each of the SASs differs, if at all, from the current AICPA generally accepted audit standards.

SAS No. 104, *Amendment to Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 104 defines *reasonable assurance* as a "high level of assurance."	• SAS No. 104 clarifies the meaning of reasonable assurance.

SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment including its internal control." • The quality and depth of the understanding to be obtained is emphasized by amending its purpose from "planning the audit" to "assessing the risk of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures."	• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning. • By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risk of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements. • The new standard emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that "generic" audit programs will not be an appropriate response for all engagements because risks vary between entities. • The term *further audit procedures*, which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed. • The term *audit evidence* replaces the term *evidential matter*.

SAS No. 106, *Audit Evidence*

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 106 defines *audit evidence* as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based."	• Previous guidance did not define audit evidence. • SAS No. 106 also describes basic concepts of audit evidence. • The term *sufficient, appropriate audit evidence*, defined in SAS No. 106, replaces the term *sufficient, competent evidence*.
• SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure;	• SAS No. 106 recategorizes assertions to add clarity. • *Assertion relating to presentation and disclosure* has been expanded and includes a new

Key Provisions	*How the SAS Differs From Current Standards*
expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures.	assertion that information in disclosures should be "expressed clearly" (understandability).
• SAS No. 106 defines *relevant* assertions as those assertions that have a meaningful bearing on whether the account is fairly stated.	• The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106.
• SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence.	• The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance.
• SAS No. 106 identifies "risk assessment procedures" as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement at the financial statement and relevant assertion levels. • SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion.	• SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risk of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately supports the auditor's opinion on the financial statements.
• SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment	• Risk assessment procedures include: – Inquiries of management and others within the entity – Analytical procedures

(continued)

Key Provisions	*How the SAS Differs From Current Standards*
procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor.	– Observation and inspection
• SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure.	• Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented.

SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*

Key Provisions	*How the SAS Differs From Current Standards*
• The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: 1. Determining the extent and nature of risk assessment procedures. 2. Identifying and assessing the risk of material misstatement. 3. Determining the nature, timing, and extent of further audit procedures. 4. Evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles.	• Previous guidance said that auditors "should consider" audit risk and materiality for certain specified purposes. SASs state that the auditor "must" consider. • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement.
• Combined assessment of inherent and control *risks* is termed the *risk of material misstatement*.	• SAS No. 107 consistently uses the term *risks of material misstatement*, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks.
• The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather	• SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach. • These two provisions of the risk assessment standards effectively eliminate the ability of

Key Provisions	How the SAS Differs From Current Standards
than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. • Assessed risks and the basis for those assessments should be documented.	the auditor to assess control risk "at the maximum" without having a basis for that assessment. In other words, you can no longer "default" to maximum control risk.
• The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management.	• SAS No. 107 provides additional guidance on communicating misstatements to management. • The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but the SAS No. 107 provides additional specific guidance on how to determine this threshold.
• The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit.	• SAS 107 provides specific guidance regarding the appropriate auditor's responses to the types of misstatements (known or likely) identified by the auditor.

SAS No. 108, *Planning and Supervision*

Key Provisions	How the SAS Differs From Current Standards
SAS No. 108 provides guidance on: • Appointment of the independent auditor. • Establishing an understanding with the client. • Preliminary engagement activities. • The overall audit strategy. • The audit plan. • Determining the extent of involvement of professionals possessing specialized skills. • Using a professional possessing information technology (IT) skills to understand the effect of IT on the audit. • Additional considerations in initial audit engagements.	• Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards. • However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan. – The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments. – The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and

(continued)

Key Provisions	*How the SAS Differs From Current Standards*
• Supervision of assistants.	extent of risk assessment and further audit procedures you perform in an audit. • SAS No. 108 states that you should obtain a written understanding with your client.

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control.	• The auditor should perform "risk assessment procedures" to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the client. • Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met), and the results of client acceptance and continuance procedures. • SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry.
• The audit team should discuss the susceptibility of the entity's financial statements to material misstatement.	• Previous standards did not require a "brain-storming" session to discuss the risk of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar (and may be performed together with) the brainstorming session to discuss fraud.
• The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess "the risk of material misstatement" and design and perform further audit procedures responsive to the assessed risk.	• SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditor's assessment of risk.

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 109 states the auditor should assess the risk of material misstatement at both the financial statement and relevant assertion levels.	• The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance. • SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level.
• SAS No. 109 provides directions on how to evaluate the design of the entity's controls and determine whether the controls are adequate and have been implemented.	• Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the understanding of internal control provides audit evidence that ultimately supports the auditor's opinion on the financial statements. • The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they have been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control.
• SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.	• Previous standard did not include the concept of "significant risks." • Significant risks exist on most engagements. • The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks.
• SAS No. 109 provides extensive guidance on the matters that should be documented.	• The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards. • Part three of this Alert lists the documentation requirements of the SASs.

SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 110 provides guidance on determining overall responses to address the risk of material misstatement at the financial statement level and the nature of those responses.	• The concept of addressing the risk of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 "repositions" your consideration of risk at the financial statement level so you make this assessment as a result of and in conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning. • SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affect individual financial statement assertions, so that you may design and perform tailored further audit procedures (substantive tests or tests of controls). • The list of possible overall responses to the risk of material misstatement at the financial statement level also has been expanded.
• Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risk of material misstatement at the relevant assertion level.	• Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear linkage between your understanding of the entity, your risk assessments, and the design of further audit procedures. • SAS No. 110 requires you to document the linkage between assessed risks and further audit procedures, which was not a requirement under the previous standards.
• SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.	• The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature.

Key Provisions	*How the SAS Differs From Current Standards*
	• SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risk of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement. • SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include: – Performing substantive tests for all relevant assertion related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risk of material misstatements – Agreeing the financial statements including their accompanying notes, to the underlying accounting records – Examining material journal entries and other adjustments made during the course of preparing the financial statements

SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 111 provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls.	• SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment.

Part Two: Fundamental Concepts

The SASs describe a process for applying the audit risk model to gather audit evidence and form an opinion about your client's financial statements. To apply this process appropriately, you will need to have a working knowledge of the key concepts upon which it is built. Those concepts include the following.

- The meaning of *reasonable assurance*
- Audit risk and the risk of material misstatement
- Materiality and tolerable misstatement
- Financial statement assertions
- Internal control
- Information technology
- Audit evidence

This part of the Alert provides a summary of these key concepts and a description of how they are used.

Reasonable Assurance

The auditing standards make numerous references to your responsibility for obtaining "reasonable assurance." For example, your audit opinion states that generally accepted auditing standards require you to "obtain reasonable assurance about whether the financial statements are free of material misstatement." "Reasonable assurance" is the fundamental threshold you use to design and perform your audit procedures. For this reason, it is important that you have a working knowledge of the term.

SAS No. 104 clarifies that reasonable assurance is a high, but not absolute, level of assurance. Put another way, you must plan and perform your audit in such a way to obtain sufficient appropriate audit evidence to reduce audit risk to a low level. Although "reasonable assurance" is a high level of assurance, it is not absolute assurance. Absolute level of assurance is not attainable because an auditor does not examine 100 percent of the entity's transactions or events and because of the limitations of the entity's internal control.

Audit Risk and the Risk of Material Misstatement

Audit risk (AR) is the risk that the financial statements are materially misstated and you fail to detect such a misstatement or appropriately modify your opinion. You should perform your audit to reduce audit risk to a low level. You need to consider audit risk at all stages of your audit.

Audit risk is a function of two components:

1. *Risk of material misstatement (RMM)*, which is the risk that an account or disclosure item contains a material misstatement. The risk of material misstatement is a combination of inherent and control risk.

2. *Detection risk*, which is the risk that you will not detect such misstatements in an account or disclosure item.

Reducing audit risk to a low level requires you to:

1. Assess the risk of material misstatement.

2. Based on that assessment, design and perform further audit procedures to reduce audit risk to an appropriate low level.

Assessing the Risk of Material Misstatement

The risk of material misstatement exists independently of detection risk. Many factors affect the risk of material misstatement, including the following.

- The client's industry, its regulatory environment, and other external factors
- The nature of the entity, for example, its operations, ownership, and financing
- The client's objectives, strategies, and related business risks
- How client management measures and reviews the company's financial performance
- The client's internal control, which includes the selection and application of accounting policies

Thus, the first step in assessing the risk of material misstatement is to gather information and gain an understanding of these and other items that create risks. Part Three of this Alert describes an audit process that begins with your gaining an understanding of these matters.

The risk of material misstatement may reside at either the financial statement level or the assertion level.

- *Financial statement-level risks* potentially affect many different assertions. For example, a lack of qualified personnel in financial reporting roles (an element of the client's control environment) may affect many different accounts and several assertions.
- *Assertion-level risks* are limited to a single assertion, for example, the valuation of inventory or the occurrence of sales.

Your response to assessed risks will differ depending on whether they reside at the financial statement or assertion level.

- Financial statement-level risks typically require an overall response, such as providing more supervision to the engagement team or incorporating additional elements of unpredictability in the selection of your audit procedures.
- Assertion-level risks are addressed by the nature, timing, and extent of further audit procedures.

For this reason, you should assess the risk of material misstatement at both the financial statement and the assertion level.

Your assessment of the risk of material misstatement (at both the financial statement and the assertion level) should be directly linked to the design and performance of further audit procedures. For example, if your understanding of the client, its environment, and its internal control lead you to assess that there is a high inherent risk that inventory quantities could be misstated, you would design tailored further audit procedures to specifically respond to that risk.

To perform audit procedures that are appropriately responsive to your assessed risks, you should define these risks in a way that incorporates the unique circumstances at the client. Generic checklists and standard audit programs may serve as a starting point for helping you to understand and assess risk, but to be truly effective, these generic audit tools need to be tailored to the specific circumstances of your client.

The process for applying the audit risk model, which is summarized in Part Three of this Alert, describes in more detail how you should link your assessment of risk to the design and performance of further audit procedures.

Risks of Material Misstatement at the Assertion Level. At the assertion level, the risk of material misstatement consists of two components:

- *Inherent risk (IR)*, which is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. Inherent risk is greater for some assertions and related account balances, classes of transactions, and disclosures than for others.

- *Control risk (CR)*, which is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the client's internal control. Control risk is a function of the effectiveness of the design and operation of the client's internal control.

Detection Risk

Detection risk is the risk that you will not detect a material misstatement that exists in an assertion. It is a function of the nature, timing, and effectiveness of audit procedures and how you apply them.

Detection risk relates to your substantive audit procedures and is managed by how you respond to the risk of material misstatement at both the financial statement and the assertion level.

- *Financial statement-level risks*. Your responses to financial statement-level risks may include assignment of more experienced personnel to the engagement team, emphasizing of the application of professional skepticism, and providing more supervision and review of the audit work performed. Appropriate choices related to these matters will help you mitigate the risks that you might select an inappropriate audit procedure, misapply audit procedures, or misinterpret the results.

- *Assertion-level risks*. In response to assertion-level risks you will determine the nature, timing, and extent of your further audit procedures that are appropriate to respond to the assessed risk.

Thus, the effectiveness of further audit procedures depends on whether you have:

1. Acquired a sufficient depth and breadth of understanding of your client to make an informed assessment of the risk of material misstatements.

2. Used your assessment of the risks of material misstatement to drive the nature, timing, and extent of your further audit procedures.

An Inverse Relationship Between the Risk of Material Misstatement and Detection Risk. At the assertion level, detection risk has an inverse relationship to the risk of material misstatement. The greater the risk of material misstatement, the less the detection risk that you should be willing to accept. Put another way, the greater the risk of material misstatement, the more reliable your substantive tests should be.

Conversely, when the risk of material misstatement is low, you can accept a greater level of detection risk. However, you are always required to perform substantive tests on all relevant assertions related to each material account balance, class of transactions, and disclosure, regardless of your assessment of the risk of material misstatement.

The model $AR = RMM \times DR$ expresses the general relationship of audit risk and its components. You may find this model useful when planning appropriate risk levels for your audit procedures, keeping in mind your overall desire to reduce audit risk to an appropriate low level.

Materiality and Tolerable Misstatement

The Concept of Materiality

The concept of materiality recognizes that some matters are more important for the fair presentation of the financial statements than are others. In performing your audit, you are concerned with matters that could be material to the financial statements. Your responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by error or fraud, are detected.

Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed by the omission or misstatement." Thus, materiality is influenced by your perception of the needs of financial statement users who will rely on the financial statements to make judgments about your client's financial position and results of operations.

How Materiality Is Used in Your Audit

Though defined by the accounting literature, materiality also is an audit concept of critical importance. Audit materiality represents the maximum amount that you believe the financial statements could be misstated and still fairly present the client's financial position and results of operations. Audit materiality affects:

1. *The nature, timing, and extent of audit procedures*. During audit planning, you should determine a materiality level for the financial statements taken as a whole. This initial determination of materiality will help you:
   - Make judgments when identifying and assessing the risk of material misstatement
   - Determine the nature, timing, and extent of your further audit procedures
2. *The evaluation of audit findings*. To form an opinion about the financial statements, you must evaluate audit findings

and determine whether the misstatements that are not corrected by the client, individually or in the aggregate, are material to the financial statements.

Quantitative and Qualitative Considerations

Although materiality commonly is expressed in quantitative terms, your determination of materiality is a matter of professional judgment that includes both quantitative and qualitative considerations. During the course of your audit, you should be alert for misstatements that could be qualitatively material. However, it ordinarily is not practical to design audit procedures to detect misstatements that qualitatively are material, and for that reason, materiality used for planning purposes considers primarily quantitative matters.

Tolerable Misstatement

During audit planning you must determine an initial level of materiality for the purposes of designing and performing your audit procedures. This initial determination of materiality is determined for the financial statements taken as a whole. However, in designing your audit procedures, you should take into account the possibility that several misstatements of amounts less than financial statement materiality could—in the aggregate—result in a material misstatement of the financial statements. That is, errors in an account or disclosure may still exist and your audit procedures may fail to detect them. For that reason, you need to allow for these undetected misstatements that may exist. You build this allowance into the overall audit strategy process by setting tolerable misstatement.

Tolerable misstatement (also referred to as tolerable error) is defined as the maximum error in a population (for example, the class of transactions or account balance) that you are willing to accept. Tolerable misstatement normally is lower than materiality for the financial statements as a whole. For each class of transactions, account balance, and disclosure, you should determine at least one level of tolerable misstatement.

For example, if for planning purposes you determined materiality to be $100,000, you could set tolerable misstatement at $60,000.

Then, you would use this tolerable misstatement level to determine the nature, timing, and extent of your further audit procedures. You could use different levels of tolerable misstatement for other account balances, classes of transactions, or assertions. See AU section 350, *Audit Sampling*, of volume 1 of the AICPA *Professional Standards* for more guidance about tolerable misstatement.

Financial Statement Assertions

Why Financial Statement Assertions Are Important

Your audit results in an opinion of the financial statements taken as a whole. However, to reach this opinion of the financial statements, most of your audit procedures should be directed at a much more detailed level, the assertion level.

Assertions are management's implicit or explicit representations regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures. Assertions fall into three categories: (1) classes of transactions, (2) account balances, and (3) presentation and disclosure.

For example, by presenting the information "Cash….$XXX" in the financial statements, management implies that:

- The cash truly exists and company has the right to use it.
- The amount presented represents all the company's cash.
- The amount presented is accurate.

Many of your audit procedures are performed not on the financial statements taken as a whole nor even at the account or disclosure level, but rather, they are directed at individual assertions.

Relating identified risks of material misstatement to misstatements that might occur at the assertion level is necessary for you to properly link assessed risks to further audit procedures.

The table titled "Categories of Assertions" provides a summary of how assertions might be grouped into various categories. You may express these assertions differently, as long as your descriptions encompass all the aspects described in the table on the following page.

CATEGORIES OF ASSERTIONS

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred and pertain to the entity.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	—
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described and information in disclosures is expressed clearly.

How You Use Assertions in Your Audit

Most of your tests of controls and substantive audit procedures are directed at specific assertions. For example, confirmation of receivables provides strong, direct evidence about the existence of those receivables and it may provide some evidence about accuracy of the gross balance. However, confirmations alone are not sufficient appropriate audit evidence to test the valuation of receivables, and the auditor should perform other appropriate procedures, such as looking at subsequent cash receipts and applying analytical procedures in testing the allowance for doubtful accounts. For this reason, to establish a clear link between your assessment of the risk of material misstatement and further audit procedures, your risk assessment procedures should be performed at the assertion level as well.

Internal Control

Definition and Description of Internal Control

Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives. These objectives fall into three categories: financial reporting, operations, and compliance with laws and regulations. In general, when performing a financial statement audit, you are most concerned with the client's financial reporting objectives, which relate to the preparation of audited financial statements.

In trying to achieve its objectives, your client faces certain risks. Internal control helps the entity achieve its objectives by mitigating the risk of "what can go wrong" in the pursuit of its objectives. Thus, there is a direct link between the entity's objectives, the risks to achieving those objectives, and internal control. Your assessment of internal control is a consideration of whether the controls mitigate financial reporting risks.

Internal control consists of five interrelated components:

1. *Control environment* sets the tone of an organization, influencing the control-consciousness of its people. It is the

foundation for all other components of internal control, providing discipline and structure.

2. Entity's *risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

3. *Information and communication systems* support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

4. *Control activities* are the policies and procedures that help ensure that management directives are carried out.

5. *Monitoring* is a process that assesses the quality of internal control performance over time.

This division of internal control into five components provides a useful framework for you to consider how different aspects of your client's internal control may affect your audit. You are not required to classify controls into a particular component. Rather, your understanding of internal control involves determining whether and how a specific control may prevent or detect and correct material misstatements.

Controls May Be Pervasive to the Entity or Restricted to an Account or Assertion

Your client's financial reporting risks (and therefore its controls) may relate to one of the following:

1. To specific classes of transactions, account balances, and disclosures

2. More pervasively to the financial statements taken as a whole (And potentially the risks may affect many assertions.)

For example, a weak control environment potentially affects many assertions and therefore is considered to operate at the financial statement level. In contrast, a control to ensure that all valid purchases are captured and recorded is restricted to specific accounts and classes of transactions and thus operates at the assertion level.

Understanding whether a control is restricted to specific classes of transactions, account balances, or disclosures or pertains pervasively to the financial statements will help you:

1. Design appropriate audit procedures to obtain information about the design of the control and whether it has been placed in operation
2. Assess the risk of material misstatement in the financial statements
3. Design substantive audit procedures
4. Assess the results of the tests of operating effectiveness of controls, if any

Control Design

The evaluation of internal control design involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements.

On every audit you should evaluate the design of internal control and determine whether controls have been implemented over all relevant assertions related to each material account balance, class of transactions, or disclosures.

Control Operations

The concept of the effective operation of controls is different from their design and implementation. The operating effectiveness of controls involves the consideration of:

- How controls were applied during the audit period
- The consistency with which they were applied
- By whom they were applied

To assess the operating effectiveness of controls, you should perform tests of controls. Unlike the evaluation of control design, tests of controls are not required on every audit, only on those audits where the auditor's risk assessment procedures includes an expectation that the controls will be effective or when substantive procedures alone do not provide sufficient audit evidence at the assertion level.

Information Technology

Your understanding of the client and its environment, including its internal control, includes an understanding of how it uses information technology (IT). A client's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, compliance objectives, and its operating units or business functions. Examples in which IT affects the entity and its environment are as follows.

- *External factors*. For example, technological innovations may have lowered the barriers to entry into the client's industry, which in turn increases competition not only for customers, but perhaps also for raw materials or qualified personnel.
- *Client operations*. For example, your client's manufacturing process may rely more on manual processes and less on technology than its competitors. Consequently, your client's financial and nonfinancial ratios will differ from others in the industry.
- *Objectives, strategies, and business risks*. For example, your not-for-profit client's innovative use of technology may allow it to raise contributions from groups of supporters who otherwise would not contribute to the organization.
- *Measurement and review of the client's financial performance*. For example, management frequently relies on information produced by the company's IT processing system to measure and review the company's financial performance. Management's ability to make decisions appropriately may rely on the accuracy, availability, and timeliness of the information processed by the IT system.

The way in which IT is deployed may vary among entities. For example, your client may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, other entities in the same industry may have complex, highly integrated systems that share data and that are used to support all aspects of the company.

Implications of IT on Your Understanding of Internal Control

The nature and characteristics of your client's use of IT in its financial information system affect its internal control. For example:

- Multiple users may access a common database of information. In such circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data.
- When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This breakdown could result in unauthorized transactions or changes to programs or data that affect the financial statements.

General vs. IT Application Controls. IT general computer controls are polices and procedures that relate to many applications and support the effective functioning and continued proper operation of information systems. For example, your client's administration of passwords can potentially affect many applications. If passwords for a given user can be stored on that person's computer, the effectiveness of internal control may be compromised because anyone who gained access to the computer could inappropriately gain access to the application, the related data, or both.

Other IT controls are applied only to specific applications, for example accounts payable, payroll, or the general accounting application. Application controls apply to the processing of individual applications. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and performing manual follow-ups of exception reports.

How the Client's Use of IT Affects Audit Planning

The use of professionals possessing IT skills is a significant aspect of many audit engagements. An IT professional may help:

- Determine the effect of IT on the audit
- Identify and assess IT risks
- Understand IT controls
- Design and perform tests of IT controls or substantive procedures

In determining whether an IT professional is needed on the audit team, you should consider factors such as the following:

- The complexity of the entity's systems and IT controls and the manner in which they are used in conducting the entity's business
- The significance of changes made to existing systems, or the implementation of new systems
- The extent to which data is shared among systems
- The extent of the entity's participation in electronic commerce
- The entity's use of emerging technologies
- The significance of audit evidence that is available only in electronic form

Audit procedures that you may assign to a professional possessing IT skills include:

- Inquiring of the client's IT personnel how data and transactions are initiated, authorized, recorded, processed, and reported and how IT controls are designed
- Inspecting systems documentation

- Observing the operation of IT controls
- Planning and performing tests of IT controls

If the use of an IT professional is planned, you should determine whether that professional is effectively functioning as a member of the audit team. If such a professional is part of your audit team, your responsibilities with respect to that professional are equivalent to those for other assistants. In such circumstances, you should have sufficient knowledge of IT matters to:

1. Communicate the objectives of the IT professional's work
2. Evaluate whether the specified audit procedures will meet your objectives
3. Evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures

Audit Evidence

The Nature of Audit Evidence

Audit evidence is all the information you use to arrive at the conclusions that support your audit opinion. Audit evidence is cumulative in nature. For example, your evidence regarding payables begins with you performing risk assessment procedures relating to the client and its environment, including its internal control. These risk assessment procedures provide audit evidence to support your conclusion about the risk of material misstatement for payables. Based on this risk assessment, you then perform further audit procedures, which include substantive tests and may include tests of controls. The results of these further audit procedures provide audit evidence that, when considered in conjunction with the evidence from risk assessment procedures, allow you to form a supportable conclusion about payables. You then repeat this process for other accounts, classes of transactions, and disclosures, and the aggregation of your conclusions provides a basis for your opinion on the financial statements taken as a whole.

The procedures that you perform on your audit provide audit evidence, but they are not the only source of audit evidence. For example, previous audits and your firm's client acceptance and continuance procedures also may be sources of audit evidence.

To determine whether you have obtained persuasive audit evidence, you should consider:

- The consistency of that evidence
- Whether the evidence was obtained from different sources or the performance of procedures that were of a different nature

A lack of consistency among individual items of audit evidence may indicate that one of the items is not reliable. For example, in a not-for-profit entity, the board of trustees' minutes reported that all of the contributions received during the year were unrestricted, but some of the donor agreements examined by you stated that the contributions are temporarily restricted. When audit evidence obtained from one source is inconsistent with that obtained from another, you should determine what additional audit procedures are necessary to resolve the inconsistency.

Ordinarily, you obtain more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of evidence considered individually. For example, reading minutes of the board and other documentation and making inquiries of several individuals about matters included in disclosures usually provide more reliable evidence than does making inquiries of one individual.

The Sufficiency and Appropriateness of Audit Evidence

Sufficiency of Audit Evidence. The sufficiency of audit evidence relates to its quantity. For example, the auditor who tests eight of the twelve monthly reconciliations between a general ledger control account and the related subsidiary ledger will obtain more evidence about the operating effectiveness of the control than the auditor who tests only two of the twelve reconciliations.

The sufficiency of audit evidence you need to support your conclusion is affected by:

- *The risk of misstatement*. The greater the risk, the more audit evidence likely to be required to support a conclusion
- *The quality of the audit evidence obtained*. The higher the quality of the evidence, the less that will be required.

Appropriateness of Audit Evidence. The appropriateness of audit evidence relates to its quality. The quality of audit evidence is a function of its relevance and its reliability in providing support, or detecting misstatements, in the accounts, classes of transactions, or assertions.

- *Relevance of audit evidence*. The results of your audit procedures may provide audit evidence that is relevant to certain assertions but not others. For example, tests of controls related to the proper authorization of a transaction will provide evidence about the occurrence assertion but not about the completeness assertion. Obtaining audit evidence relating to a particular assertion, in this example, the occurrence of a transaction, is not a substitute for obtaining audit evidence regarding another assertion, in this example, completeness.
- *Reliability of audit evidence*. The reliability of audit evidence is influenced by its source and by its nature. Reliability also depends on the individual circumstances under which it is obtained, including its timing.

Generalizations about the reliability of various kinds of audit evidence can be made; however, when considering such generalizations keep in mind that they are subject to important exceptions. Even when audit evidence is obtained from sources external to the client, circumstances may exist that could affect the reliability of the information obtained. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful.

- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

- Audit evidence is more reliable when it exists in documentary form (whether paper, electronic, or other medium). For example, minutes of an audit committee meeting are more reliable than a subsequent oral representation of the matters discussed at the meeting.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

Typically, you obtain more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, if the company lacks documentation to support its intent with regard to equity securities (which affect how those securities are classified and presented in the financial statements), you may have no choice but to rely on management's representations regarding their intent. Management's representations may be less reliable than a written record, but if you obtain representations from several sources (for example, from different members of management) and these representations are consistent with the client's past history of selling equity investments, then you may find the consistency of the evidence from different sources to be persuasive.

An increased quantity of audit evidence may compensate for less reliable audit evidence, it cannot compensate for audit evidence that lacks relevancy. For example, a confirmation of an accounts receivable balance is not relevant to the valuation of the allowance account. Increasing the number of receivables confirmations will not provide you with any additional evidence relating to the allowance for doubtful accounts.

Determining Whether You Have Obtained Sufficient, Appropriate Audit Evidence. You may find it necessary to rely on audit evidence that is persuasive rather than conclusive. However, to obtain the reasonable assurance required to support an opinion about the financial statements, you must not be satisfied with audit evidence that is less than persuasive.

Part Three: Applying the Audit Risk Model

This part of the Alert provides a summary of the audit process. Even though some requirements and guidance are presented in a way that suggests a sequential process, audit fieldwork involves a continuous process of gathering, updating, and analyzing information throughout the audit.

The following is an overview of how an auditor should apply the audit risk model in practice.

- *Gather information about the entity and its environment, including internal control.* Your first step in the process is to gather information about those aspects of the client and its environment that will allow you to identify and assess risks. Evaluating the design of the client's controls and determining whether they have been implemented are an integral part of this process.
- *Understand the entity and its environment, including its internal control.* Based on the information gathered, you should be able to identify what could go wrong in specific relevant assertions related to each account balance, class of transactions, or disclosures.
- *Assess the risk of material misstatement.* Next, you will use your understanding of the client and its environment, including its internal control, to assess the risk of material misstatement that relate to both financial statement level and specific assertions. To assess risks you will need to:
  - Identify the risk of material misstatement
  - Describe the identified risks in terms of what can go wrong in specific assertions
  - Consider the significance and likelihood of material misstatement for each identified risk

- *Design overall responses and further audit procedures*. You should address the risk of material misstatement at both the financial statement and the relevant assertion level.
  - The risk of material misstatement at the financial statement level has a more pervasive effect on the financial statements and affects many assertions. In addition to developing assertion-specific responses, financial statement-level risks may require you to develop an overall, audit-wide response, such as assigning more experienced audit team members.
  - Assertion-level risks pertain to a single assertion and should be considered when you design and subsequently perform further audit procedures. Depending on the results of your risk assessment procedures, further audit procedures may encompass a combined approach using both tests of controls and substantive procedures or a substantive audit approach. Either approach is directed at relevant assertions related to each material account balance, class of transactions, and disclosures. However, regardless of your assessment of risks, you need to perform substantive audit procedures on all relevant assertions related to each material account balance, class of transaction, or disclosure.

Information Gathering

Information Needed About the Client and Its Environment to Identify and Assess the Risk of Material Misstatement

Obtaining an understanding of your client and its environment is an essential part of every audit. Not only does this understanding allow you to identify and assess the risk of material misstatement, it also allows you to exercise informed judgment about other audit matters such as:

- Materiality
- Whether the client's selection and application of accounting policies are appropriate and financial statement disclosures are adequate

- Areas where special audit consideration may be necessary, for example, related party transactions
- The expectation of recorded amounts that you develop for performing analytical procedures
- The design and performance of further audit procedures
- The evaluation of audit evidence

Not all information about a client or its environment is relevant for your audit. In general, the information you should gather about your client is that which allows you to assess the risk that specific assertions could be materially misstated. The following table summarizes the various categories of information you should obtain about your client.

Understanding the Client and Its Environment

On every audit you are required to gather information and obtain an understanding of the client and its environment. This understanding consists of the following aspects.

- *External factors*, including
  - Industry factors such as the competitive environment, supplier and customer relationships, and technological developments.
  - The regulatory environment, which includes relevant accounting pronouncements, the legal and political environment, and environmental requirements that affect the industry.
  - Other matters such as general economic conditions.
- *Nature of the client*, which includes its operations, its ownership, governance, the types of investments it makes and plans to make, how it is financed, and how it is structured.
- *Objectives and strategies and related business risks*, which may result in material misstatement of the financial statements taken as a whole or individual assertions.
- *Measurement and review of the client's financial performance*, which tells you which aspects of the client's performance that management considers to be important.
- *Internal control*, which consists of five components: the control environment, risk assessment, information and communication, control activities, and monitoring. These components may operate at the entity level or the individual transaction level. To obtain an appropriate understanding of internal control will require you to understand and evaluate the design of all five components of internal control and to determine whether the controls are in use by the client.

Risk Assessment Procedures

The audit procedures you perform to obtain an understanding of the entity and its internal control are referred to as *risk assessment procedures*. Some of the information you obtain by performing risk assessment procedures you will use to support your assessments of the risks of material misstatement. Risk assessment procedures include:

1. Inquiries of management and others at the client
2. Analytical procedures
3. Observation and inspection

You need to gather audit evidence to support your assessment of the risk of material misstatement. It is not acceptable to simply deem control risk to be "at the maximum" without support. Your risk assessment procedures provide the audit evidence necessary to support your risk assessments, which in turn, support your determination of the nature, timing, and extent of further audit procedures. Thus, the results of your risk assessment procedures are an integral part of the audit evidence you obtain to support your opinion on the financial statements.

A Mix of Procedures. Except for internal control, you are not required to perform all the procedures for each of the five aspects of the client and its environment discussed previously. However, in the course of gathering information about the client, you should perform all the risk assessment procedures.

With regard to obtaining an understanding about the design of internal control and determining whether they have been implemented, inquiry alone is not sufficient. Thus, for these purposes, you should supplement your inquiries with other risk assessment procedures.

Other Procedures That Provide Relevant Information About the Client. Following include some procedures you might consider.

- *Assessing the Risk of Material Misstatement Due to Fraud*. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), directs you to perform certain audit procedures to assess the risk of material misstatement due to fraud. Some of these procedures also may help gather information about the entity and its environment, particularly its internal control. For this reason, you should:

- Coordinate the procedures you perform to assess the risk of material misstatement due to fraud with your other risk assessment procedures
- Consider the results of your assessment of fraud risk when identifying the risk of material misstatement

• *Other Information*. When relevant to the audit, you also should consider other knowledge you have of the client that can help you assess risk. This other information may include:

- Information obtained from your client acceptance or continuance process
- Experience gained on other engagements performed for the entity

Updating Information From Prior Periods. If certain conditions are met, you may use information about the client you obtained in prior periods as audit evidence in the current period audit. However, when you intend to use information from prior periods in the current period audit, you should determine whether changes have occurred that may affect the relevance of the information for the current audit. To make this determination, you should make inquiries and perform other appropriate audit procedures, such as walk-throughs of systems.

Gaining an Understanding of the Client and Its Environment

The gathering of information, by itself, does not provide you with the understanding of the client that is necessary for you to assess risk. For you to assess the risk of material misstatement and perform further audit procedures, you need to synthesize the information gathered to determine how it might affect the financial statements. For example:

- Information about the client's industry may allow you to identify characteristics of the industry that could give rise to specific misstatements. For example, if your client is a construction contractor that uses long-term contract accounting, your understanding of the client should be sufficient to allow you to recognize that the significant estimates of revenues and costs create a risk of material misstatement.
- Information about the ownership of your client, how it is structured, and other elements of its nature will help you identify related party transactions that, if not properly accounted for and adequately disclosed, could lead to a material misstatement.
- Your identification and understanding of the business risks facing your client increase the chance that you will identify financial reporting risks. For example, your client may face a risk that a new company may enter its market, and that new entrant could have certain business advantages (for example, economies of scale or greater brand recognition). The potential risk of material misstatement of the financial statements related to this business risk might be obsolescence or overproduction of inventory that could only be sold at a discount.
- Information about the performance measures used by client management may lead you to identify pressures or incentives that could motivate client personnel to misstate the financial statements.
- Information about the design and implementation of internal control may lead you to identify deficiencies in control design, which increase the risk of material misstatement.

Evaluating the Design of Internal Control

A sufficient understanding of internal control is one that allows you to evaluate the design of internal control and to determine whether controls have been placed in operation. This threshold describes a substantial understanding of internal control.

Requirements for Evaluating Control Design. On every audit, you should obtain an understanding of internal control that is of sufficient depth to enable you to:

1. Assess the risks of material misstatement of the financial statements, whether due to error or fraud
2. Design the nature, timing, and extent of further audit procedures

To meet this threshold of sufficiency, at both the entity and relevant assertion level, you should:

1. Evaluate the design of controls that are relevant to the audit and determine whether the control—either individually or in combination—is capable of effectively preventing or detecting and correcting material misstatements.
2. Determine that the control has been implemented, that is, that the control exists and that the entity is using it.

Your evaluation of internal control design and the determination of whether controls have been implemented are critical to your assessment of the risks of material misstatement. It is not possible to develop a reliable assessment of the risk of material misstatement absent a sufficient understanding of internal control. For this reason, you are required to perform risk assessment procedures to gather information and form an understanding of internal control on every audit. Even if your initial audit strategy contemplates performing only substantive procedures for all relevant assertions related to material transactions, account balances, and disclosures, you still need to evaluate the design of your client's internal control.

How to Evaluate Control Design. In evaluating control design, it is helpful to consider:

- Whether control objectives that are specific to the unique circumstances of the client have been considered for all relevant assertions for all significant accounts and disclosures
- Whether the control or combination of controls would—if operated as designed—meet the control objective

- Whether all controls necessary to meet the control objective are in place

Determining If the Control Has Been Implemented

It may be possible that the way in which a control is applied by an entity differs from the description of the control in a policy manual or from one individual's understanding of how the control is applied. For example, your client's accounting policy manual may state that physical inventory accounts are performed annually. However, because of increases in the volume of transactions, the client deviates from this stated policy and counts some inventory items twice a year. This practice is not reflected in the policy manual and is not known by all individuals in the company. Determining whether a control has been implemented is important because it confirms your understanding of control design.

The determination of whether a control has been put in place and is in use involves obtaining evidence about whether those individuals responsible for performing the prescribed procedures have:

- An awareness of the existence of the procedure and their responsibility for its performance
- A working knowledge of how the procedure should be performed

Determining whether the control has been implemented does not require you to determine whether the control was performed properly throughout the audit period.

Distinguishing Between Evaluation of Design and Tests of Controls. Obtaining an understanding of the design and implementation of internal control is different from testing its operating effectiveness.

- *Understanding design and implementation* is required on every audit as part of the process of assessing the risks of material misstatement.
- *Testing the operating effectiveness* builds on your understanding of internal control design and implementation and is necessary only where the auditor's risk assessment procedures include an expectation that the controls will be effec-

tive or when substantive procedures alone do not provide you with sufficient audit evidence at the assertion level.

The procedures necessary to understand the design and implementation of controls do provide some limited evidence regarding the operation of the control.[2]

However, the procedures necessary to understand the design and implementation of controls generally are not sufficient to serve as a test of their operating effectiveness for the purpose of placing significant reliance on their operation. For example, obtaining audit evidence about the implementation of a manually operated control at a point in time does not provide audit evidence about the operating effectiveness of control at other times during the period under audit.

Examples of situations where the procedures you perform to understand the design and implementation of controls may provide sufficient audit evidence about their operating effectiveness include:

- Controls that are automated to the degree that they can be performed consistently provided that IT general controls over those automated controls operated effectively during the period.
- Controls that operate only at a point in time rather than continuously throughout the period. For example, if the client performs an annual physical inventory count, your observation of that count and other procedures to evaluate its design and implementation provide you with evidence that you consider in the design of your substantive procedures.

Evaluating Design and Implementation in the Absence of Control Documentation. For smaller companies, the company's evidence supporting the design and implementation of some elements of internal control may not be available in documentary form. For example, the entity may lack:

2. For example, a walkthrough that traces a transaction from its inception through its recording is considered a test of one transaction. Examination of several documents evidencing the operation of a control at a key control point may also be considered as a test. Generally, the evidence required to rely on the operation of the control will be greater than that required to simply assess whether it has been placed in operation.

- A written code of conduct that describes management's commitment to ethical values
- A formal risk assessment process

Without adequate documentation of controls, the risk assessment procedures available to you to understand control design are limited to inquiry and observation. As risk assessment procedures, both inquiry and observation have limitations, and accordingly, absent adequate documentation, you should consider whether the information you have gathered about internal control is sufficient to evaluate its design.

Inadequate documentation of the components of internal control also may be a control deficiency. For example, the lack of appropriate documentation may impair management's ability to communicate control procedures to those responsible for their performance or to monitor control performance effectively.

Discussion Among the Audit Team

The members of the audit team should discuss the susceptibility of the client's financial statements to material misstatement. This discussion will allow team members to exchange information and create a shared understanding of the client and its environment, which in turn will enable each team member to:

- Gain a better understanding of the potential for material misstatement resulting from fraud or error in the assertions that are relevant to the areas assigned to them
- Understand how the results of the audit procedures that they perform may affect other aspects of the audit.

This discussion among the audit team could be held at the same time as the discussion among the team related to fraud, which is required by AU section 316.

Assessing the Risk of Material Misstatement

Considerations at the Financial Statement Level

You should use your understanding of the client and its environment—which includes your evaluation of the design and implementation of internal control—to assess the risk of material misstatement. To make this assessment, you should:

1. Identify risks throughout the process of obtaining an understanding of the entity, its internal control, and its environment.

2. Relate the identified risks to what can go wrong at the relevant assertion level.

3. Consider whether the risks could result in a material misstatement to the financial statements.

4. Consider the likelihood that the risks could result in a material misstatement of the financial statements.

Financial Statement-Level and Assertion-Level Risks. You should identify and assess the risks of material misstatement at both the financial statement level and the relevant assertion level.

1. *Financial statement-level risks*. Some risks of material misstatement relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. These risks at the financial statement level may be identifiable with specific assertions at the class of transaction, account balance, or disclosure level.

2. *Relevant assertion-level risks*. Other risks of material misstatement relate to specific classes of transactions, account balances, and disclosures at the assertion level. Your assessment of risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures.

Risks that exist at the financial statement level, for example, those that pertain to a weak control environment or to management's process for making significant accounting estimates, should be related to specific assertions. For example, risks related to the client's process for making accounting estimates would affect those assertions where an accounting estimate was necessary (for example, the valuation of assets).

In other instances, it may not be possible for you to relate your financial statement-level risks to a particular assertion or group of assertions. For example, it may not be possible for you to determine which assertions will or will not be affected by a weak control environment. Financial statement-level assertions that can not be related to specific assertions will require you to make an overall response, such as the way in which the audit is staffed or supervised.

How to Consider Internal Control When Assessing Risks. Your evaluation of internal control design and the determination of whether controls have been implemented are integral components of the risk assessment process. When making risk assessments, you should identify the controls that are likely to either prevent or detect and correct material misstatements in specific assertions. For example, procedures relating to the client's physical inventory count may relate specifically to the existence or completeness of inventory.

Individual controls often do not address a risk completely in themselves. Often, only multiple control activities, together with other components of internal control (for example, the control environment, risk assessment, information and communication, or monitoring), will be sufficient to address a risk. For this reason, when determining whether identified controls are likely to prevent or detect and correct material misstatements, you generally organize your risk assessment procedures according to significant transactions and accounting processes (for example, sales, cash receipts, or payroll), rather than general ledger accounts.

Identification of Significant Risks. As part of your risk assessment, you should identify significant risks, which are defined as those risks that require special audit consideration. For example, if your client is named as a defendant in a patent infringement lawsuit that may threaten the viability of its principal product, you could consider as significant risks, the risks that the lawsuit (1) would not be appropriately recorded or disclosed in accordance with generally accepted accounting principles or (2) may affect the entity's ability to continue as a going concern.

Significant risks arise on most audits. When you determine that a risk is a significant risk, your audit procedures should include (but not be limited to):

- Obtaining an understanding of internal control, including relevant control activities, related specifically to those significant risks.
- If you plan to rely on the operating effectiveness of controls related to significant risks, testing the operating effectiveness of those controls in the current period. That is, using evidence about operating effectiveness that you obtained in prior periods is not appropriate.
- Substantive procedures specifically designed to address the significant risk.

Significant risks should be distinguished from transactions or events that have a high inherent risk, which could be mitigated by the client's internal controls. For example, because of the nature of your client and the industry in which it operates, you might assess a high inherent risk on revenue recognition. However, the client may have controls over revenue recognition; you would then obtain an understanding of such controls and determine whether they are implemented and, if appropriate, test their operating effectiveness. This circumstance may not warrant special audit consideration and thus may not be a significant risk.

The determination of whether a transaction or event is a significant risk is a matter for your professional judgment.

Considerations at the Assertion Level

Part Two of this Alert provides a definition of audit risk (AR) in which:

$$AR = RMM \times DR$$

where RMM is the risk of material misstatement and DR is detection risk

The risk of material misstatement is described as "the entity's risk," which means that it is independent of your audit. You can control detection risk by changing the nature, timing, and extent of your audit procedures. For example, to decrease the planned level of detection risk, you could perform more extensive substantive tests.

You cannot control the risk of material misstatement as you can detection risk because RMM exists independently from your audit procedures. However, to properly gauge the detection risk you are willing to accept, you need to assess the risks of material misstatement. The risk assessment process described in the SASs is designed to allow you to gather information and assess the risks of material misstatement so you can design further audit procedures that reduce audit risk to an acceptably low level.

Determining Materiality and Tolerable Misstatement

You should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The determination of materiality will assist you in (1) making judgments when identifying and assessing the risk of material misstatement and (2) determining the nature, timing, and extent of your further audit procedures. In determining financial statement materiality, you will often apply percentages to benchmarks. The determination of materiality, including the selection of the appropriate benchmark and percentages, is a matter of your professional judgment and depends on the nature and circumstances of your audit.

In addition to the quantitative considerations, you should be alert for misstatements that could be qualitatively material, for example, misstatements that may change a loss into income or vice versa, may potentially affect loan covenants, or may increase management's compensation.

After you determine the financial statement materiality, you should set a tolerable misstatement, which is the adjustment of the financial statement materiality to the assertion level. Tolerable misstatement will assist you in assessing the risk of material misstatement and in designing and performing further audit procedures.

Because the entity's circumstances may change as the audit progresses, you should reassess the financial statement materiality and tolerable misstatement levels initially determined. Failure to do so may result in you failing to obtain sufficient audit evidence to support your opinion.

Responding to Assessed Risks

Linking Assessed Risks to Further Audit Procedures

The risk assessment process culminates with your articulation of the account balances, classes of transactions, or disclosures where material misstatements are most likely to occur. This assessment of risk relates identified risks to what can go wrong at the assertion level and the way in which misstatements are likely to occur. Your risk assessment provides the basis for designing and performing further audit procedures.

You can think of your assessment of risks as having two dimensions: direction and amplitude. Direction relates to where misstatements can occur, that is, the specific assertions related to an account, class of transactions, or disclosure. Amplitude relates to the possible magnitude of the misstatement that could occur. Magnitude is a function of two variables: the potential significance of the misstatement (for example, whether it is material) and the likelihood of a misstatement occurring (for example, remote, likely). Your evaluation of the design and implementation of internal control affects all elements of your risk assessment process.

Further Audit Procedures

You perform further audit procedures to obtain the audit evidence necessary to support your audit opinion. Further audit procedures consist of either tests of controls or substantive tests. Often, a combined approach using both tests of controls and substantive procedures is an effective approach. You are not precluded from adapting a substantive audit approach provided that you have and document an appropriate basis for this approach.

In determining the nature, timing, and extent of further audit procedures, you should design and perform further procedures whose nature, timing, and extent are responsive to the assessed risk of material misstatement at the relevant assertion level. You should provide and document a clear linkage between your assessment of the risk of material misstatement and the nature, timing, and extent of the further audit procedures.

Audit procedures performed in previous audits and example procedures provided by illustrative audit programs may help you understand the types of further audit procedures that are possible for you to perform. However, prior year procedures and example audit programs do not provide a sufficient basis for determining the nature, timing, and extent of audit procedures to perform in the current audit. Your assessment of the risk of material misstatement in the current period is the primary basis for designing further audit procedures in the current period.

Evaluating Audit Findings

In evaluating whether the financial statements are presented fairly, you must consider the effects, both individually and in the aggregate, of misstatements (known and likely) identified by you that are not corrected by the client.

Your consideration and aggregation of misstatements should include both of the following:

- Known misstatements, which are the amount of misstatements specifically identified
- Likely misstatements, which include (1) projected misstatements in the account balances or classes of transactions that you have examined and (2) differences between management's and the auditor's judgments concerning accounting estimates that the auditor considers unreasonable or inappropriate.

Misstatements should be aggregated in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole.

Before considering the aggregate effect of identified uncorrected misstatements, the auditor should consider each misstatement separately to evaluate:

1. Its effect in relation to the relevant individual classes of transactions, account balances, or disclosures, including qualitative considerations.
2. Whether, in considering the effect of the individual misstatement on the financial statements taken as a whole, it is appropriate to offset misstatements. For example, it may be appropriate to offset misstatements of items within the same account balance in the financial statements.
3. The effect of misstatements related to prior periods. In prior periods, misstatements may not have been corrected by the entity because they did not cause the financial statements for those periods to be materially misstated. Those misstatements might also affect the current period's financial statements.

In aggregating misstatements, you should include the effect on the current period's financial statements of those prior period misstatements. When evaluating the aggregate uncorrected misstatements, you should consider the effects of these uncorrected misstatements in determining whether the financial statements are free of material misstatement.

There are quantitative and qualitative materiality considerations, and you should consider both when evaluating audit results. Because of qualitative considerations, misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

Evaluating Whether the Financial Statements Taken as a Whole Are Free of Material Misstatement

You must evaluate whether the financial statements taken as a whole are free of material misstatement. In making this evaluation, you should consider the evaluation of the uncorrected (known and likely) misstatements you identified during the audit. When concluding about whether the effect of misstatements, individually or in the aggregate, is material, you should consider the nature and amount of the misstatements in relation to the nature and amount of items in the financial statements under audit. For example, an amount that is material to the financial statements of one entity may not be material to the financial statements of another entity of a different size or nature. Also, what is material to the financial statements of a particular entity might change from one period to another.

If you believe that the financial statements taken as a whole are materially misstated, you should request management to make the necessary corrections. If management refuses to make the corrections, you must determine the implications for the auditor's report.

If you conclude that the effects of uncorrected misstatements are not material, you should consider that the financial statements themselves could still be materially misstated because of additional misstatements that you did not detect. As the aggregate misstatements approach materiality, the risk that the financial statements may be materially misstated also increases. Accordingly, you should consider the effect of undetected misstatements in concluding whether the financial statements are fairly stated.

The Iterative Nature of Auditing

An audit of financial statements is a cumulative and iterative process. As you perform planned audit procedures—whether they be risk assessment procedures, substantive tests, or tests of controls—the audit evidence you obtain may cause you to modify the nature, timing, or extent of other planned audit procedures. Information may come to your attention that differs significantly from the information on which the risk assessments were based.

For example, the extent of misstatements that you detect by performing substantive procedures may alter your judgment about the risk assessments and may indicate a material weakness in internal control. Or, analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement. In such circumstances, you should reevaluate the planned audit procedures based on the revised consideration of assessed risks.

Audit Documentation

General Documentation Requirements

In general, you should document certain matters pertaining to each step in the risk assessment process. This audit documentation should provide a clear understanding of the work performed, the source of the information, and the conclusions reached.

The form and content of audit documentation are for you to determine using professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), provides general guidance regarding the purpose, content, ownership, and confidentiality of audit documentation. Examples of common documentation techniques include narrative descriptions, questionnaires, checklists, and flowcharts. These techniques may be used alone or in combination.

The form and extent of your documentation are influenced by the following:

- The nature, size, and complexity of the entity and its environment
- The availability of information from the entity
- The specific audit methodology and technology used in the course of the audit

For example, documentation of the understanding of a complex information system in which a large volume of transactions are electronically initiated, authorized, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an information system making limited or no use of IT or for which few transactions are processed, documentation in the form of a memorandum may be sufficient. Generally, the more complex the entity and its environment, and the more extensive the audit procedures performed by the auditor, the more extensive your documentation should be. The specific audit methodology and technology used in the course of the audit will also affect the form and extent of documentation.

Specific Documentation Requirements

The SASs require you to document the following matters.

- The levels of materiality and tolerable misstatement, including any changes thereto, used in the audit and the basis on which those levels were determined.
- The discussion among the audit team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, including how and when the discussion occurred, the subject matter discussed, the audit team members who participated, and significant decisions reached concerning planned responses at the financial statement and relevant assertion levels.
- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment, including each of the components of internal control, to assess the risks of material misstatement of the financial statements, the sources of information from which the understanding was obtained, and the risk assessment procedures.
- The assessment of the risks of material misstatement both at the financial statement level and at the relevant assertion level and the basis for the assessment.
- The significant risks identified and related controls evaluated.
- The overall responses to address the assessed risks of misstatement at the financial statement level.
- The nature, timing, and extent of the further audit procedures.
- The linkage of those procedures with the assessed risks at the relevant assertion level.
- The results of the audit procedures.

- The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit.
- A summary of uncorrected misstatements, other than those that are trivial, related to known and likely misstatements.
- Your conclusion about whether uncorrected misstatements, individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.

Uncorrected misstatements should be documented in a manner that allows the auditor to:

- Separately consider the effects of known and likely misstatements, including uncorrected misstatements identified in prior periods.
- Consider the aggregate effect of misstatements on the financial statements.
- Consider the qualitative factors that are relevant to the auditor's consideration of whether misstatements are material.

Resource Central

The AICPA will offer continuing professional education courses, including a self-study course as well as a group study course. In addition, the new risk assessment standards will be a topic of discussion in various AICPA conferences in which AICPA presenters will further explain the standards.

On the Bookshelf

Future AICPA Audit Guide on Risk Assessment and Internal Control

The AICPA is currently developing an Audit Guide to aid in implementing the new risk assessment standards. In addition, the AICPA is revamping its existing Audit Guide titled *Consideration of Internal Control in a Financial Statement Audit*. The current development plan envisions combining these two guides into one audit guide. This audit guide should be available by mid-2006 and can be purchased by contacting the AICPA/CPA2Biz Service Center at (888) 777-7077 or online at www.cpa2biz.com.

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Any comments that you have about this Alert may be e-mailed to lpombo@aicpa.org or mailed to:

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